Legal Aspects of Private Farm Leases

Province of British Columbia
Ministry of Agriculture and Food

Legal Aspects of Private Farm Leases

A study prepared for the B.C. Ministry of Agriculture and Food, Economics Branch, by Lundgren, Menzies, Chartered Accountants and Salloum, Doak & Company, Barristers and Solicitors, Kelowna, B.C.

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Foreword

As production costs continue to increase, farmers are looking at alternatives to create or maintain economically viable farm units. With the high costs associated with land ownership, leasing of land for production is attracting more interest than ever before.

BRITISH COLUMBIA CENSUS FARMS

(Sales of $1,200 or more per annum)

Operators classed by tenure	1971	1976	1981
No. of tenants	501	994	1 017
Nos. of part owner part tenant	2 591	3 305	3 351

This publication has been prepared to provide the reader with a basic understanding of the legal aspects of leasing farmland. It concerns itself with private rather than government leases.

Discussed are the pros and cons of leasing versus land ownership, the importance of an agreement in writing, the terms and provisions to be considered, tax and estate planning and the implications of other government programs.

It is not the intention of the authors to analyze the economic implications of leasing, but to provide an overview from a legal perspective and to address specific concerns farmers and landlords should address when contemplating entering into a lease arrangement.

A number of sample lease agreements covering orchard, grain, pasture, livestock, vegetables and dairy have been drafted in conjunction with this publication and are available upon request through your local Ministry of Agriculture and Food office. It is intended they provide you and your solicitor with a guide to identifying your individual leasing needs.

This publication was written by Roger Lundgren, chartered accountant with Lundgren, Menzies, and by Ronald T. Solmer, solicitor with Salloum, Doak and Company. The project was funded by D.A.T.E. (Demonstration of Agricultural Technology and Economics) and the Financial Management Training Project under supervision of Terry Peterson, P.Ag., Supervisor of Farm Business Management, B.C. Ministry of Agriculture and Food, Vernon.

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SUPPLEMENTARY FORMS AVAILABLE

1. Orchard Lease
2. Grain Lease
3. Vegetable Lease
4. Pasture Lease
5. Livestock Lease
6. Dairy Lease

These forms, available from your local office of the Ministry of Agriculture and Food, are meant as SAMPLE LEASES ONLY. You are advised to seek the advice of a solicitor when preparing a lease to suit your individual needs.

INTRODUCTION

The purpose of this publication is to provide British Columbia farmers with information on leasing arrangements. While it is being published in conjunction with sample leases for various types of farming operations, it should be emphasized that the publication is simply a guide and the sample leases may not cover all the individual details necessary to provide a workable lease in your own particular situation. It is important for the individual farmer to retain professional advice when entering into a leasing agreement.

This publication focuses on leases between private individuals rather than government leases. In the event that you as a farmer are considering entering into a lease of Crown lands, it is suggested that you contact the nearest Ministry of Agriculture and Food office to receive details as to the availability and the terms under which Crown land is leased for farming purposes.

It has become apparent in recent years that the number of farms being operated under leasehold arrangements has increased dramatically. Increasing land costs and high interest rates are but two of the reasons why farmers, and particularly young farmers, are looking to lease land rather than purchase land. By leasing land, a farmer can avoid spending large amounts of capital in purchasing land thereby freeing that capital for land and crop improvements, and increasing the efficiency of the farm.

It is essential that leasing agreements be in written form. This not only applies to leases in excess of three years, which are required by statute to be in writing, but it also applies to leases which have a term of less than three years.

A written lease encourages both parties to look at the advantages and disadvantages and the respective obligations of each party prior to the commencement of the lease. By doing so, the parties tend to resolve potential problems at the outset with the result that both parties feel more comfortable in the knowledge that their obligations and commitments have been clearly set out. Furthermore, should a conflict arise during the term of the lease, a written lease, if properly drawn, will set out the obligations of each party and provide a procedure by which conflicts can be resolved.

There are a number of advantages to farming under a leasing arrangement, for example:

1. As was previously mentioned, one can farm on a larger scale as there is less capital tied up in long term and intermediate term assets;

2. Under a cash lease, the rent can be deducted as an operational expense;

3. If a person is contemplating purchasing a certain parcel of land, it may be advantageous to lease the land first in order to learn about the soil resources, climate, etc.;

4. A new farmer can determine whether or not he wants to make a career out of farming before committing himself to the purchase of a farm.

There are certain disadvantages in farming under a lease arrangement, namely:

1. The insecurity of tenure (except under long-term leases) discourages long-term improvements;

2. Depending on who the Lessor is, one may be faced with a situation where there is a significant amount of management interference from the Lessor.

3. By leasing, one does not benefit from inflation and real estate speculation and their resulting upward pressure on land values.

One common concern regarding leasing is the belief that it makes it more difficult to obtain credit because of the lack of collateral which the Lessee has. In many cases that is a misconception. Obviously, an established farmer who has clear title to his land can use his equity to obtain financing at a more favourable rate than a farmer who is just starting out.

New farmers who have a limited amount of capital to inject into the business, gain no particular advantage by purchasing farmland rather than leasing it. This is because a farmer who has recently purchased land will have very little equity to use as collateral for an operating line of credit.

There are, unfortunately, situations in which a farmer who is leasing land will have difficulty in obtaining credit. For example, where government licences or quotas such as milk and chicken quotas are involved, a Lender will find little security in the quotas. A Lender will invariably look to the farmer for a tangible form of security such as a mortgage on land. Obviously, a farmer with enough equity in land is in a position to obtain financing more easily than one who does not.

Finally, each farmer must determine, not only if he can devise the means to obtain required financing, but more importantly, if his farming income will be sufficient to meet his obligations to the Lender.

The Nature of Leases and the Laws Affecting Them

A lease is defined as "a contract by which one party, while reserving a reversion to himself, confers on the other the right to exclusive possession of real property for a limited time and as a rule receives a recompense, in the shape of rent normally in money."[1] In other words, a written lease is a document creating an interest in land for a fixed period, usually in consideration of the payment of rent.

Invariably, a lease agreement will result in more than creating a simple interest in land, and in fact, is a bilateral contract including a number of covenants or promises between the Lessor and Lessee such as a promise to pay rent, do repairs, operate the land in a good and husband-like manner, etc. A lease may contain an infinite number of covenants and conditions, the extent and nature of which depend solely upon the wishes of the two parties and the bargain which they arrive at.

There are a number of statutes which affect leases and while they need not necessarily concern the individuals entering into the lease, since the lawyer drafting the lease should be well aware of them, they are important enough to be mentioned at this time:

1. The Statute of Frauds, R.S.B.C. 1979, chapter 393—Section 1 of The Statute of Frauds effectively says that a lease for a term of greater than three (3) years must be in writing to be enforceable. A lease which is of a term less than three (3) years may be made verbally but as is noted in the introduction, a verbal lease is not recommended no matter what the term of the lease may be.

2. *Land Title Act*, R.S.B.C. 1979, chapter 219—Section 20 of the *Land Title Act* effectively states that a lease for a term of greater than three (3) years must be registered in order to be enforceable against third parties. In other words, should one have a lease for a term of greater than three (3) years, which is unregistered, and the Lessor sells the land which is being leased, the Purchaser is not deemed to have notice of the Lease and consequently, it is invalid as against the Purchaser. A lease which is for a term of less than or equal to three (3) years does not have to be registered in order to be enforceable against a third party so long as there is actual occupation by the Lessee under the Lease.

3. *Property Law Act*, R.S.B.C. 1979, chapter 340—Section 16 of the *Property Law Act* says that a lease does not have to be executed under seal unless the executing party is a corporation.

4. *Land Transfer Form Act*, R.S.B.C. 1979, chapter 221 (Part 2)—Where a lease is expressed to be made "In Pursuance of the *Land Transfer Form Act*—Part 2," any concise or abbreviated terms in the lease which are noted in the *Land Transfer Form Act* shall have the expanded meaning as set out in that Act.

As was mentioned above, these statutes should not be of any particular concern to the Lessee or Lessor, as they are procedural in nature and are common enough that all lawyers who prepare leases will be well aware of them.

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[1] The Encyclopedia of Forms and Precedents, Fourth Edition, Volume II, p. 3, Butterworth's, 1965.

The Essential Terms of a Lease

There are certain terms which are essential in order to have a document which constitutes a good and valid lease, namely, the lease must contain a description of the parties, a description of the land, a commencement clause, a duration clause, a rent clause, and all material terms of the contract not incidental to the Landlord/Tenant relationship.

1. PARTIES

The lease must indicate the parties, namely, the Lessor, being the person who owns the lands, and the Lessee, being the person leasing the lands. In addition, the lease should have a covenant of the Lessor that he has valid title to the lands which are being leased. Where one is dealing with corporate entities, one should also have the principals of the companies, in addition to the companies themselves, guaranteeing the terms of the lease.

2. DESCRIPTION

The lease document should indicate the legal description of the lands being leased. Where a portion of a lot is being leased, there should be a survey plan indicating the exact portion of the property which is being leased. If a survey plan is not attached, the lease will not be accepted for registration in the Land Title Office. It is also suggested that any machinery which may go with the lease should also be described and that such descriptions should include the serial numbers of same.

3. COMMENCEMENT CLAUSE

A lease must specify the starting date from which time the Lessee is entitled to possession of the lands.

4. DURATION

The lease must set out the length of the term of the lease from the starting date.

5. RENT

The lease must contain a clause indicating the amount of rent payable and the times at which the rent is payable. The key consideration here is to determine a fair rent which adequately covers the cost of the contributions made by each party to the lease. These costs include such things as interest on investment, labour, management, depreciation and operating expenses. Realistic estimates must be used in calculating such costs. For instance, when valuing the Lessor's investment allowance, two types of earnings must be considered. Firstly, there is the "annual interest return on investment" (RENT), and secondly, there is the "long term appreciation in value" (CAPITAL GAIN). The rental and capital gain earnings are then combined to give the total return on land investment. Thus, if the Lessor considers that a reasonable total return to investment would be 15 per cent and land values have increased to a rate of 10 per cent per year then a 5 per cent interest on investment allowance should be used in determining the Lessor's investment cost contribution.

The three most commonly used types of lease rental clauses are:

(a) Crop/Share Rental Clause

(b) Cash Rental Clause

(c) Flexible Cash Rental Clause.

(a) Crop/Share Rental:

The most common form of lease rental is done on what is known as a crop/share basis. The advantage of a crop/share lease is that the risks associated with prices and production are shared by both parties in the same proportion as their share of the crop. Furthermore, the Lessor stands to make more

money on a crop/share lease than on other forms of lease rental arrangements provided the Lessee is a good farmer. On the other hand, should the Lessee be a poorer farmer then the Lessor may well make less money under a crop/share scheme. Appendix I provides a rental worksheet showing how the respective crop shares of the Lessor/Lessee could be determined.

(b) Cash Rental:

Under a cash rental lease there is a fixed cash payment usually made in advance. A cash lease is beneficial in the sense that it may be deducted as an expense by the Lessee. On the other hand, it has the disadvantage of fixing the amount of rent without any consideration for such variables as crop size and price. By entering into a cash lease, the Lessee takes the risk that if the crop proceeds are low he will suffer from a proportionately high lease payment while conversely, if crop proceeds are high the Lessor does not have the opportunity to benefit therefrom. In determining the amount of cash rent to be charged, rental rates in the area are a major factor. However, if those rates are unavailable or unsatisfactory then a cash rate may be determined by using the worksheet shown in Appendix I to determine the Lessor's percentage share of costs. The cash rent would then equal the Lessor's percentage share of costs × anticipated yield × expected price.

(c) Flexible Cash Rental:

The flexible cash lease combines some of the features of both the crop/share lease and the cash lease. The rental payments can vary with fluctuations in production or price or both. Normally, flexible cash leases are used to adjust the rental rate in accordance with the price obtained for the commodity produced. By doing so, the Lessor's rent is guaranteed in relation to the quantity but not the price of the commodity with the result that the risk of change in prices is shared by both the Lessor and Lessee. The following example illustrates a method used to determine rent under a flexible cash lease:

Assume: 100 acres are cultivated and that the average yield is 1,000 boxes of apples/acre. Also assume that the normal crop/share in the district is ¼ share to Lessor, then:

Step 1—Average Apple Production equals number of acres (100) × yield/acre (1,000) or 100,000 boxes

Step 2—Lessor's Normal Share =
100,000 boxes × ¼ share = 25,000 boxes

Step 3—Rent = Lessor's Normal Share × Prevailing Price for apples.

6. MATERIAL TERMS OF CONTRACT

The lease should also contain all material terms of contract which are not incidental to the Lessor/Lessee relationship including covenants or conditions, exceptions or reservations. Examples of the types of covenants and conditions, etc., used in leases will be discussed in further detail in the sample leases attached. A check list of the potential terms of contract which may be used in any particular lease arrangement are as follows:

1. Provision for re-entry by the Lessor on nonpayment of rent or nonperformance of covenants;
2. Provision that the Lessee will not assign or sublet the lease without leave from the Lessor;
3. Provision as to which party will be responsible for taxes;
4. Provision that the Lessor covenants with the Lessee for quiet enjoyment;
5. Provision that the lease is binding on the heirs, successors and assigns of the parties to the lease;
6. Covenant by the Lessor that he has good title in the land being leased and that he has the right to lease the said lands;
7. Provision that the Lessor shall have the right to enter and inspect the leased lands subject to reasonable notice to the Lessee;

8. Covenant by the Lessee that he will apply for coverage under the *Farm Income Assurance Act*, Federal Stabilization and other similar government programs which are available now or in the future and further provisions as to how the costs of such programs, if any, are to be shared between the Lessee and Lessor;

9. Covenant by the Lessee that he will maintain insurance on such items as are agreed between the parties and also provision as to how the costs of such insurance are to be shared between the parties;

10. Provision that the Lessee is not entitled to log or mine the leased lands;

11. An arbitration clause providing the procedure by which disputes between the Lessor and Lessee can be determined in a summary manner;

12. A renewal clause providing for the renewal of the lease for a further term, normally of the same length of time as the previous lease, and providing for the rent to be determined according to the rental rates which exist at the time of renewal;

13. A clause providing that on default of payment of rent or default of any of the covenants within the lease, for example; "that the Lessee has become insolvent or bankrupt," that the lease may be terminated at the option of the Lessor and that the Lessor is entitled to immediate possession.

14. Maintenance provisions:

    (a) that the Lessee will operate the farm in a good and husbandlike manner;
    (b) where one is dealing with long-term plantings such as fruit trees, provision setting out that the Lessee is responsible for replacing dead and diseased trees and also setting out the manner in which the cost of replacing such trees is to be shared between the Lessee and Lessor;
    (c) where dealing with yearly crops, a provision setting out the method of crop rotation which is to be followed by the Lessee;
    (d) covenant by the Lessee that he will repair and maintain all improvements;
    (e) covenant by the Lessee to keep down all noxious weeds;
    (f) where dealing with a crop/share lease, provision for how the cost of chemicals, fertilizer and seed treatments are to be shared between the Lessee and Lessor;
    (g) a clause setting out manner in which the cost of any new improvements are to be shared between the Lessee and Lessor;
    (h) a clause listing any improvements made by the Lessee which the Lessee wishes to remove from the land at the end of the lease term and specifying that such improvements are deemed not to be fixtures.

15. The Lessee may also want a provision in the lease giving him a right of first refusal. Such a clause would give the Lessee the opportunity to purchase the leased lands from the Lessor before the said lands are offered for sale to a third party. Examples of such provisions are provided in the sample leases.

The above clauses are by no means the only clauses which may be used in a lease. Rather, they are a list of the more common terms and provisions used in most leases. Additional clauses and provisions may be required to suit your particular needs. You are urged to discuss your particular needs with your solicitor.

Effect of Income Tax Act on Lease Operations

(NOTE—The comments noted below relate to the *Income Tax Act* as it existed at December 15, 1981. Tax law is subject to frequent change and professional advice should be sought on any changes since that date.)

Some important sections of the *Income Tax Act* affecting farm leases are:

(a) Cash method of accounting for farm income (Section 28);
(b) Farmers five year averaging (Section 119);
(c) Tax free rollovers to a younger generation (Sections 70 and 73);
(d) Non-resident withholding tax (Section 215);
(e) Capital Cost Allowance

Some other provisions (e.g., interest deductibility), may also have effect but are of limited applicability and therefore will not be discussed here.

CASH METHOD (*Income Tax Act*, Section 28)

Under the cash method of accounting for taxable income, which is generally used by farmers, rental payments are an expense in the fiscal period in which they are paid, and are income to the landlord in the same period.

Under the accrual method of accounting, the payments would have to be allocated (e.g., on a monthly basis), over the period to which they applied.

If one party to the lease is on a cash method and the other on an accrual method, then a situation could arise where the income or expenses may be reported in different years for tax purposes.

FIVE YEAR BLOCK AVERAGING (*Income Tax Act*, Section 119)

For purposes only of the five year block averaging available to farmers, rental income based on crop share arrangements can qualify for the averaging calculation as income from a farming business. Cash rental income, on the other hand, is considered to be income from property and not business income, and therefore, does not qualify for the five year averaging provision.

TAX FREE ROLLOVERS TO YOUNGER GENERATION (*Income Tax Act*, Sections 70 and 73)

To qualify for these tax free rollover provisions in the *Income Tax Act*, farm land must be used in the business of farming by the farmer, his spouse, or his child. Land which is rented to an outsider would, therefore, not qualify for the rollover provision. Income taxes on the capital gain could become payable in the event of the death of the owner while the land was rented, even though the land passed to his children.

This point would be of particular concern if the owner was of advanced age or in ill health.

NON-RESIDENT WITHHOLDING TAX

If the owner of the property is a non-resident of Canada, the tenant is required to deduct a withholding tax. A person who pays rent to a non-resident must withhold and remit to Revenue Canada 25 per cent of the rental amount. For residents of some countries (for example, Great Britain or the U.S.A.) the withholding amount is reduced to 15 per cent by International Tax Treaties.

The requirement to withhold applies to cash rentals and crop share rentals paid in cash.

If the Lessee does not deduct and remit the required amount, Revenue Canada will first try to collect from the Lessor. But if the Lessor does not pay, then the Lessee will be held liable for the withholding amount.

CAPITAL COST ALLOWANCE

Improvements to rented property that would otherwise qualify for depreciation, may be depreciated as Class 13 Leasehold Improvements. For example, major improvements to existing buildings or a new building erected on leased property must be depreciated as leasehold improvements.

Leasehold improvements are written off for tax purposes over the greater part of five years, or the term of the lease plus the first renewal option, up to a maximum of 40 years.

Federal/Provincial Government Programs

A person who farms under a leasing arrangement is entitled to the benefits of existing Federal and Provincial insurance and stabilization programs. It is the responsibility of the person who produces the commodity (in this case the Lessee) to register for the various programs. From the point of view of the Lessor, it is important to ensure that a covenant or promise be put in the lease requiring the Lessee to sign up for such programs. By doing so, the Lessor is ensured that the Lessee will have an income and thereby operate as a form of insurance on the rental payments to be made to the Lessor.

It is also advisable that a Lessee contact his local Federation of Agriculture representative or the British Columbia Ministry of Agriculture and Food to determine what the program requirements are as it may be necessary to provide a copy of your executed lease as proof that you are the actual producer.

Termination of Lease

A lease will normally terminate or come to an end at the completion of the term set out in the lease. In some instances, the parties to a long-term lease may also want provisions within the lease allowing them to legally terminate the lease prior to the expiration of the leasehold term provided for in the lease. When doing so, it is important to set out the conditions under which such early termination will be allowed. In addition, the lease should set out the compensation, if any, which will be due as a result of early termination.

A lease should also give the Lessor the right to terminate the lease, if he so chooses, where the Lessee has failed to pay the rent reserved under the lease and/or failed to live up to the covenants set out in the lease. A lease should also provide that where the Lessee has failed to perform essential farm work, the Lessor has the right to have someone else perform the work and charge the Lessee for the costs incurred.

Summary

The above discussion of leasing arrangements is intended to provide farmers in British Columbia with an overview regarding the nature of leases and the specific concerns which farmers and landowners should address when entering into a lease arrangement.

A number of sample leases covering various types of farming have been drafted in conjunction with this publication and are available upon request from your local branch of the Ministry of Agriculture and Food. Hopefully they will provide you and your solicitor with a guide upon which to determine your individual leasing needs.

One often hears younger people, especially those who grew up on a farm, complain that with land prices the way they are today it is virtually impossible for them to start farming. At the same time, there are increasing numbers of people who have little or no desire to farm the land buying farmland as an investment. Clearly, there is an opportunity for these two groups to get together and enter into an arrangement which will not only be beneficial to both but also to society as a whole by increasing the productivity of our farmland. Leasing is the tool by which that end can be achieved.

It is hoped that this publication will assist in making the public aware of the leasing alternative and that it will remove some of the concerns and questions which farmers have regarding this alternative.

Rental Rate Worksheet*

LESSOR'S ANNUAL COST PER CULTIVATED ACRE		TENANT'S ANNUAL COST PER CULTIVATED ACRE	
Investment Cost $\frac{\$375{,}000 \times 5\%}{25}$	= $750.00	Equipment:	
		Depreciation	$ 300.00
		Investments ($3,000 × 15%)	450.00
Taxes	50.00	Cultural Cash Costs	1,000.00
		Harvest Cost	750.00
		Irrigation System:	
		Depreciation	50.00
		Investment ($1,000 × 15%)	150.00
		Water	50.00
		Crop Insurance	100.00
		General Insurance	50.00
		Interest on Operating Capital	300.00
TOTAL	$800.00	TOTAL	$3,200.00

Total Annual Contributions = $800 + $3,200 = $4,000

Lessor's Share = $\frac{800}{4{,}000} = 20\%$

Lessee's Share = $\frac{3{,}200}{4{,}000} = 80\%$

* The above worksheet is based on orchard rental situation and on the assumption that the Lessor is contributing a minimum amount to the leasing arrangement, namely the land and the taxes. In the event that the Lessor is contributing more than the above (i.e., equipment or irrigation system), then appropriate adjustments must be made. It should be noted that the above worksheet is merely an example and the calculations provided therein do not necessarily reflect the true costs involved in any one particular leasing situation. Once again it should be emphasized that there may be other factors involved in determining the rental rate, such as a desire on the part of the Lessor to see the farm well maintained, in which case the Lessor may be willing to lease the lands to a conscientious Lessee at a reduced rate. As always the key word is "compromise" as both the Lessor and the Lessee must agree on a leasing format which both of them use to satisfy their respective needs.

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